

COMMENTS TO THE PRESIDENT'S COMMISSION ON THE UNITED STATES POSTAL SERVICE

**Submitted by
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These comments represent my own personal views. I am submitting them because of my interest in postal rate issues and in the effectiveness of the postal system in the United States. My background is that I worked for 17 years in rate-related areas for the Postal Service, and then for 10 years at the Postal Rate Commission. I retired from the Postal Rate Commission in October of 2002. My training is primarily in economics.

It may be that the Commission will decide that steps should be taken in a direction that would subject the Postal Service to additional competition and give the Postal Service residual-claimant characteristics. This would provide needed incentives and would require major changes in the situation surrounding labor. I do not advocate such changes at this time, primarily because the effects could be very large and there are lesser steps that can be taken. On the point of large effects, I believe, for example, that a step like eliminating the mail box rule could cause massive quantities of mail to move to private competitors almost overnight.

Because of the extent to which the Postal Service is facing competition in virtually all of its product areas, I believe the Postal Service needs to be led in the direction of becoming the moral equivalent of a lean, mean, delivery machine. I hope it is clear that I mean this in the most

friendly and cordial sense of being productive in the United States today. The problem is that being less than highly productive and highly efficient just does not cut it. The list of lesser steps that I wish to bring to the Commission's attention is provided below.

1. I believe the Commission should ask the Postal Service to prepare a specific list of barriers that it believes exist, and that prevent it from becoming the kind of lean, mean, delivery machine that everyone understands should be possible. Once it prepares this list, the Commission should focus on the advocacy of reducing the barriers.

2. The Postal Service's total factor productivity index was designed by one of the most knowledgeable productivity experts in the world. Nevertheless, and independent of that talent, the Commission should seek appropriate review of the index's methods and formulas. The Commission should ask specifically if the index properly accommodates, in a way that is suitable for both short-term and long-term analysis, changes in product mix, changes in the degrees of worksharing, changes in mail characteristics (including the average haul), changes in service levels (including the point where all First-Class Mail was shifted to air service), changes in the number of delivery points, and changes in modes of delivery. Attention should also focus on the suitability of the index for comparisons with indexes of other industries. If improvements are needed, they should be recommended. If the index has limitations, they should be spelled out. If the index passes all tests, the Commission should confirm its merit and recommend that it continue to be accorded substantial attention in the future.

3. The Commission should carefully examine the argument of the Postal Service that increases in the number of delivery points are a special burden and a drag on its ability to contain costs. I believe the real problem is a decline in the volume per delivery point, not an increase in the number of delivery points. In fact, since these new delivery points bring additional volume, I believe the Postal Service is better off with the new points than without them. Note should be made that new delivery points are often low in cost because: 1) they are often arranged through cluster boxes or low-cost curblane routes; 2) they often occur within established delivery areas and therefore increase the density of delivery, which should help reduce unit costs; and 3) if the Postal Service has any of the economies of scale and joint production that it often claims, the new delivery points should add to these economies.

4. The Commission should consider whether the Postal Service can remain competitive and continue the favorable rate treatment currently provided to parcels in Alaska. In fact, inquiry could find other high-cost cells as well. I know it is not politically correct to point out such things, but the costs are real and they cannot be ignored. No postal service can be competitive and provide the kind of low-cost services needed, when it is saddled with abnormal cost burdens.

5. The Commission should consider whether it is time to allow certain First-Class rates to vary with distance. It may even be that doing so would not require a change in the law, although the issue has never been tested in the courts. The Reorganization Act says that the rates for each class for letters sealed against inspection "shall be uniform throughout the United States, its territories, and possessions." Section 3623(d). It is possible to be uniform and still vary with

distance. Noteworthy is that in regard to the rate for books and certain other materials, the Act says the rates “shall be uniform . . . and shall not vary with the distance transported.” Section 3683(a). It is clear that Congress knew the difference between uniformity and varying with distance, and it does not appear to have prohibited rates that vary with distance for letters sealed against inspection.

My thought on this is that a bulk First-Class (automation) rate could be created for mail entered at a destination facility. For a small discount, this could change the face of mail in the United States, with massive changes in national efficiency. At the present time mailers have no incentive to mail pieces near their destination or in convenient places, even when doing so would cost them little or nothing. Mailers understand that the Postal Service will carry the mail anywhere, by air, at no additional charge. Incentives are terribly important.

6. It may be possible to save a lot of money by restructuring the retail network. I know others have written about this, so I won't say more.

7. The system in place for selling postage (in particular, stamps) is very inefficient. This may be because of a legal constraint, or a belief in the existence of a legal constraint, requiring that all First-Class postage be sold at face value, regardless of the cost. If this is a legal constraint, it should be changed. Surcharges should be placed on high-cost ways of selling postage and discounts should be given for low-cost, usually bulk, ways of selling postage. A few incentives would go a long way toward changing people's behavior and lowering costs.

8. Without relaxing any universal service obligation, consideration could be given to delivering every other day in some high-cost areas.

9. Guidance on rate setting is contained in section 3622(b) of the Act. Even as interpreted by the courts, this guidance is in some cases vague and has led in some instances to decisions reflecting bad economics and bad business. With the experience we now have, consideration should be given to changing some of that guidance. Several thoughts are presented below.

a. Section (b)2 refers to value of service. The notion is that mail with a high value of service will receive a high markup over costs, and that mail with a low value of service will receive a low markup over costs. In other words, how much value is there to be drawn on in marking up the costs. Clearly a concept of value is needed that relates to the value that is there. Over a period beginning in the mid-1800s, economists have developed such a concept of value and it relates to the sensitivity of volume levels to changes in rates, or to elasticity. There is no disagreement among economists on this point.

The Postal Service and the Commission have recognized this elasticity-based value-of-service concept, referring to it as *extrinsic* value. The problem is that the Postal Service and the Commission have also developed an additional value-of-service concept, referred to in postal proceedings as *intrinsic* value. This concept involves pointing to descriptive characteristics of mail subclasses, such as receiving service by air, being easy to use, or being sealed against inspection, and

concluding that value exists. This is a hollow concept without meaning or content. It may be the case that certain characteristics are valued, but if they are, there will be inelasticity. If descriptive characteristics are not associated with inelasticity, they should not be relied on to increase the markup. The law should be changed to make it clear that the appropriate economic value of service is intended. This intrinsic concept has in all likelihood hurt Express Mail and Priority Mail. In today's market, for example, even though there is virtually no value available to be drawn on to increase rates relative to costs, the Postal Service proposes and the Commission recommends a high mark up for Priority Mail.

b. The same section (b)2 refers to the value of the mail service to the "recipient" of the mail. Since the recipient does not make mailing decisions, no one has ever figured out how such a notion should be accommodated in rates. It should be removed. The recipient does *respond* to the mail, sometimes, and the interests of the recipient may be reflected in decisions made by the mailer, but the feelings of the recipient have no bearing on the value that is available to be drawn on to increase rates above costs.

c. Section (b)3 refers to the "attributable" costs of the mail classes. No definition of attribution is given. With the advice of the courts, the rate process has focused on the costs that are "caused" by the mail classes, including, but not limited to, marginal costs. The problem is that the word "caused" does not have

meaning in any costing theory, and can lead anywhere. For example, one could argue that transportation costs are not caused by the volume of mail, but rather are caused by the fact that our cities are so far apart.

Economists almost universally understand and recommend that the costing concept relevant to rate decisions is marginal cost. Marginal cost has a specific meaning and analyses can be designed to estimate it. The law should be amended to make it clear that the primary cost reference for rates should be estimates of marginal cost. As a further step, there is also agreement that the economist's notion of incremental cost should be used in after-the-fact tests for cross subsidies, but not for basic costing.

Reliance on improper costing, although apparently appropriate under the present law, has led to at least two important costing decisions that may be affecting the reasonableness of rates. (1) The advertising costs of Priority Mail are being attributed and marked up. Although sometimes accompanied by a sale price, the most basic of advertising concepts begins with rates that are already in place, and asks if a degree of advertising might increase demand enough to result in an increase in profits, even after the advertising is paid. Under current procedures in postal rate setting, however, advertising expenditures increase the cost base, which is then marked up, thus leading to rates that are even *higher* on two counts. This is counterproductive and defeats the purpose of the advertising. Since advertising costs are not marginal costs, defining costs as marginal, as suggested above, would solve this problem. Note that the advertising costs may be part of the incremental

costs of Priority, although, even here, there is a question. The question is that under the burden test, a complex version of the incremental cost test, the advertising may come back on another subclass. (2) A costing concept known in postal parlance as “single-subclass stops” has been used to increase the attributable costs of Standard mail. Such costs are not marginal. Intervenors have spent millions of dollars presenting testimony on this costing concept. Under any accepted costing principles, such costs would not be attributed. The change in the law suggested above would clarify the costing concept and solve this problem as well.

10. Many observers in recent years have argued that the Postal Service needs more pricing “flexibility,” particularly in competitive areas. The fear of this, in some quarters, has been that granting pricing flexibility would give the Postal Service the freedom to lower all competitive prices down to the marginal (or otherwise attributable) level, with no contribution to fixed costs. There is an easy way to solve this problem. Simply allow the Postal Rate Commission to give the Postal Service a price floor (possibly called an inverse price cap) for competitive classes, and give the Postal Service the freedom to make any changes desired, as long as the weighted average index of prices does not go below the floor. In this way, the Commission’s judgement on an appropriate contribution would be available. If this requires a change in the law, it is a minor adjustment.

11. I am sure it is understood, without my saying so, that the Postal Service's biggest problem is a labor problem. There is too much unrest, inadequate incentives, not enough hustle, and too much difficulty aligning labor input with workload. I am not an expert on labor. I will allow others to comment on this problem.